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UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

IN RE:)
)
RICHARD D. SMITH, III)
MEREDITH B. SMITH)
)
Debtors)
)

CHAPTER 7

CASE NO. 02-82858-MHM

JOSEPH MARZULLO)
WILLIAM HUDANICH d/b/a)
M&H INTEGRATED SERVICES)
)

Plaintiffs)

ADVERSARY PROCEEDING
NO. 03-9085

v.)

RICHARD D. SMITH, III)
)

Defendant)

MEMORANDUM OPINION AND ORDER

Joseph Marzullo and William Hudanich, d/b/a M & H Integrated Services ("Plaintiff"), filed this adversary proceeding seeking a determination that its claim is nondischargeable pursuant to 11 U.S.C. § 523(a)(4). Plaintiff filed a motion seeking summary judgment on a theory of collateral estoppel. Plaintiff is a judgment creditor of Debtor Richard D. Smith, III ("Defendant"), and alleges that the doctrine of collateral estoppel prevents Defendant from relitigating the issues determined in the prepetition state court lawsuit, and that the facts established by that lawsuit show that Defendant committed defalcation while acting in a fiduciary capacity. The judgment obtained by Plaintiff resulted from a failure by Defendant to respond to a complaint in New York

State Court. This court has jurisdiction over the claims pursuant to 28 U.S.C. § 157 and 28 U.S.C. § 1334. This action is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(I). For the reasons set forth below, the court *grants* Plaintiff's motion for summary judgment.

Statement of Material Facts

This adversary proceeding arises from Defendant's prepetition operation of his construction services corporation, Construction Concepts and Designs, Inc. ("CCD"). In April 2000, CCD, of which Defendant was an officer and agent, entered into an agreement with Plaintiff which provided that Plaintiff would supply subcontracting construction services to build a bank branch in New York. CCD acted as the general contractor and an intermediary between Plaintiff and the bank who was building the branch.

When Plaintiff completed construction of the branch bank in early 2001, Defendant's corporation failed to pay the amount owed Plaintiff for labor and materials. In April 2001, Plaintiff filed suit against Defendant and CCD in New York State Court, alleging against both a breach of agreement and liability under Article 3-A of New York's Lien Law. New York's Lien Law ensures payment to subcontractors by contractors and their fiduciaries for services rendered. New York law provides that defendants can be held personally liable under Article 3-A of New York's Lien Law. *See, Atlas Bldg. Systems, Inc. V. Rende*, 653 N.Y.S.2d 694 (N.Y.App. Div. 1997).

Only Defendant, and not CCD, was served. Defendant failed to file an answer to Plaintiff's original complaint, and failed to appear before the New York State Court. On November 26, 2001, the New York court entered an order awarding a default judgment

in favor of Plaintiff on the original complaint.¹ On May 6, 2002, Plaintiff filed in the State Court of Dekalb County an affidavit and copy of the New York judgment in compliance with Georgia's Uniform Enforcement of Foreign Judgment Law. O.C.G.A. § 9-12-13. Defendant moved to set aside the default judgment asserting lack of personal jurisdiction. The Dekalb court, however, concluded that the New York court was authorized to exercise jurisdiction over Defendant. On October 31, 2002, the Dekalb County court denied Defendant's motion to set aside, ruling that Defendant had sufficient minimum contacts with New York to satisfy the due process requirements to have obtained the default judgment.

On December 17, 2002, Defendant filed a Chapter 7 bankruptcy petition in the Northern District of Georgia. Plaintiff seeks to prevent the discharge of the judgment debt owed by Defendant pursuant to 11 U.S.C. § 523(a)(4). In Plaintiff's motion for summary judgment, the question presented is whether the doctrine of collateral estoppel applies and entitles Plaintiff to a summary judgment on a dischargeability claim.

Motion for Summary Judgment Standards

In accordance with Federal Rule of Bankruptcy Procedure 7056, which incorporates Federal Rule of Civil Procedure 56, summary judgment is available only in the absence of any genuine issue of material facts so as to make the moving party entitled to judgment as a matter of law. *Celotex Corp. v. Catrett*, 477 U.S. 317 (1986). The moving party has the burden of establishing that no such factual issue exists. *Id.* The court will read the entire record in the light most favorable to the party against whom summary judgment is sought. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242 (1986).

¹ The New York Supreme Court severed Defendant's corporation from the action, having never been served.

Discussion & Conclusion of Law

The Bankruptcy Code provides a claim is nondischargeable if it arose as a result of “fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny.” 11 U.S.C. § 523(a)(4). Through this provision, the Code offers a means of denying those individuals who do not qualify as “honest but unfortunate debtors” the benefits of a fresh start. *Grogan v. Garner*, 498 U.S. 279 (1991).

The principles of the Erie Doctrine require a federal court to give a state court judgment the same preclusive effect as would be given that judgment under the law of the state in which the judgment was rendered. *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938). The preclusive effect of a state court determination in a subsequent federal action “is determined by the rules of the state where the prior action occurred.” 28 U.S.C. § 1738; *Allen v. McCurry*, 449 U.S. 90 (1980); See, *In re St. Laurent*, 991 F.2d 672 (11th Cir. 1993); 18 C. Wright, A. Miller & E. Cooper, *Federal Practice and Procedure: Jurisdiction* § 4469. The mandate of “full faith and credit” to a state court judgment applies in dischargeability issues just as it does in any other court action. *Marrese v. American Academy of Orthopedic Surgeons*, 470 U.S. 373 (1985); 28 U.S.C. § 1738. Collateral estoppel principles apply to dischargeability issues in bankruptcy proceedings. *In re St. Laurent*, 991 F.2d 672, citing, *Grogan*, 498 U.S. 279. (1991); *In re Bilzerian*, 100 F.3d 886 (11th Cir. 1996). In the present case, New York law will apply.

Defendant’s counsel argues that Plaintiff’s claim on a theory of collateral estoppel should fail because it does not meet the requirement that the issue be “actually litigated.” Certain federal courts have noted that default judgments entered by federal courts cannot collaterally estop subsequent litigation because such judgments cannot

be properly characterized as "actual litigation." See, *Spilman v. Harley*, 656 F.2d 224, 228 (6th Cir. 1981); *United States v. Gottheiner (In re: Gottheiner)*, 703 F.2d 1136, 1140 (9th Cir. 1983); see also, Restatement (Second) of Judgments § 27 (1982). Those federal cases, however, dealt with a prior judgment by a *federal court* applying the *federal doctrine of collateral estoppel*, which includes a requirement that an issue be actually litigated.

Under current New York law, the doctrine of collateral estoppel bars relitigation of an issue if *two* requirements are met. Collateral estoppel will apply only where (1) an identity of issues decided in the prior action are decisive of the current action, and (2) the defendants had a full and fair opportunity to contest the prior determination. *Brown v. Citibank, N.A.*, 757 N.Y.S.2d 586 (N.Y. App. Div. 2003); *Kaufman v. Eli Lilly & Company*, 65 N.Y.2d 449, 455 (N.Y. App. Div. 1985) ("There are now but two requirements which must be satisfied before the doctrine is invoked"). "Actual litigation is not a requirement for collateral estoppel under New York law." See, *New York v. Sokol*, 113 F.3d 303, 306 (2d Cir. 1997). See also, *Lanzano v. City of New York*, 609 N.Y.S.2d 891, 892 (N.Y. App. Div. 1994); *Kaufman v. Eli Lilly & Company*, 65 N.Y.2d 449 at 455. If the defendant has been given an opportunity to contest the prior determination, and did not take advantage of this privilege, the defendant has no legal ground to complain. See, *Perino v. Cohen (In re Cohen)*, 92 B.R. 54 (Bkrcty. S.D.N.Y. 1988). Therefore, the two elements of collateral estoppel required by New York law that Plaintiff in the instant case must satisfy are whether the diversion of trust funds by a fiduciary under Article 3-A of New York Lien Law is a defalcation within the meaning of 11 U.S.C. § 523(a)(4), and whether Defendant had a full and fair opportunity to contest the prior default judgment.

Identity of Issues

The New York court entered a default judgment finding that Defendant had violated Article 3-A New York Lien Law. Plaintiff argues a diversion of trust funds under Article 3-A is equivalent to the term “defalcation” within the meaning of 11 U.S.C. § 523(a)(4), and, thus, Plaintiff has established an identity of issues. The purpose of Article 3-A of the New York Lien Law is to ensure that those who have directly expended labor and materials to improve real property at the direction of a general contractor receive payment for the work performed. *Atlas Bldg. Systems, Inc. V. Rende*, 653 N.Y.S.2d 694 (N.Y.App. Div. 1997). The general contractor assumes a fiduciary duty under this law, and the contractor’s officers will be held personally liable for any breach of trust. *Id.* A diversion of funds that are considered to be held in a statutorily created trust by a fiduciary under New York Lien Law is a “defalcation” within the meaning of 11 U.S.C. § 523(a)(4). *In re Dobrayel*, 287 B.R. 3 (Bkrtcy. S.D.N.Y. 2002); *In re Phipps*, 217 B.R. 427 (Bkrtcy. W.D.N.Y. 1998); *In re Silba*, 170 B.R. 195 (Bkrtcy. E.D.N.Y. 1994); *Matter of Kawczynski*, 442 F.Supp. 413 (W.D.N.Y. 1977). Therefore, an identity of issues is present between the liability under the New York Lien Law and an act of defalcation under 11 U.S.C. § 523(a)(4).

Full and Fair Opportunity

Defendant had a full and fair *opportunity* to contest the prior determination. The basis for the New York state court's decision to enter judgment as to liability in this case was Defendant's failure to comply with the basic rules of procedure - answering the complaint and appearing before the court. Defendant cannot argue or establish an absence of a full and fair opportunity to litigate the issues in the prior action. New York law clearly establishes that actual litigation is not a requirement for collateral estoppel as

Defendant argues. In consideration of the state court's decision, Defendant will not be given the opportunity to litigate the issue in bankruptcy court.

Because Plaintiff has established an identity of issues and a full and fair opportunity to contest the prior determination, collateral estoppel applies to prevent relitigation in this adversary proceeding. Pursuant to 11 U.S.C. § 523(a)(4), Plaintiff's claim versus Defendant is nondischargeable. Accordingly, it is hereby

ORDERED that Plaintiff's motion for summary judgment as a matter of law is granted. Judgment in favor of Plaintiff will be entered in accordance with this order.

IT IS SO ORDERED, this the 29th day of March, 2004.



MARGARET H. MURPHY
UNITED STATES BANKRUPTCY JUDGE